

Investment perspectives: Brazil Elections

Brazil held its presidential elections over the last month and the results of the final run-off were announced on Sunday night. Lula da Silva triumphed over incumbent Bolsonaro in this election, although, at the time of writing, Bolsonaro hasn't officially acknowledged the results.

The margin of victory for Lula over Bolsonaro in the second-round run-off was narrow at just under 2%, but the electronic voting system is credible and the result has been widely recognised by the international community and by Brazilian institutions such as Congress. We think of Lula as a centre-left politician who will respect the need for orthodox economic policies. In the election campaign he has tracked to the centre, for example by naming PSDB stalwart Geraldo Alckmin as his VP pick, and so we expect his approach to mirror the conservative policies that he adopted in his first term in 2002. Like Bolsonaro he will want to maintain additional spending on welfare payments for the poor, and therefore need to generate support in Congress for a relaxation of the spending ceiling. With net debt back down below 60% of GDP, however, and growth prospects looking relatively buoyant, this should be manageable. Given the majority for the centre and centre-right in Congress, we do not expect more ambitious fiscal profligacy to gain traction.

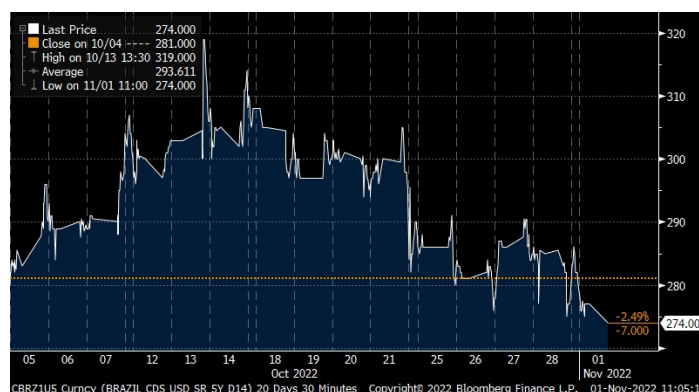
Beyond the narrow fiscal outlook, RBC BlueBay co-chairs the Investor Policy Dialogue on Deforestation and Lula's policies on that front are much better than Bolsonaro, who has been a difficult counter-party. In his victory speech, Lula again committed his government to zero deforestation, meaning that he will need to rebuild capacity in the federal agencies tasked with tackling illegal activity in the Amazon and other biomes. On this front and others, relations with the international community will be much more comfortable under Lula. Many local participants in the Brazilian financial sector were broadly sympathetic to Bolsonaro, so their disappointment will show up in the price action in local assets near term but we think that will be short-lived. Brazil's external debt stock is modest, at around 8% of GDP, and so we do not expect a major reaction in hard currency bonds. Medium-term, we like the combination of continued fiscal orthodoxy and a more consensual political stance, and therefore maintain modest overweight allocations to Brazil mainly through local assets.

Market review

The currency and rates initially sold off slightly, but later rallied and recovered the losses over the past week. Overall, this reaction can be concluded to be relatively muted.



On hard currency side, as proxied by 5yr CDS contracts, the markets have taken this election outcome relatively well, and the CDS has moderately tightened.



Our Positioning

Against a global backdrop of monetary policy tightening, sticky inflation and relentlessly strengthening US dollar, Brazilian central bank has been one of the most proactive in terms of hiking rates and fighting inflation. There are initial signs that the hiking cycle of the Brazilian central bank may be starting to enter its moderation phase in the medium term.

- Based on that, we have maintained an overweight allocation to rates due to its high carry and possibility of slight rally going forward. We would also intend to increase our BRL position tactically, against our existing slight overweight position.
- On hard currency, we have maintained an underweight allocation due to the technical pressure on the whole asset class, and somewhat tight valuation of Brazil in that context.

Outlook

Brazil isn't immune to the overall global themes of monetary policy tightening, entrenched inflation and moderation in global growth, but given the more proactive central bank, we believe Brazil may find itself in the sweet spot once the normalisation begins. The growth outlook remains relatively constructive and the valuations are highly attractive. We would however be cautiously monitoring any fiscally expansionary policies introduced by the new president as they can compromise this relatively positive picture for Brazil.

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